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SUBJECT: REVISED BUDGET SEEN AS EXPANSIONARY

SUMMARY
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¶1. (u) Serbia's new government on June 14 presented a 2007 budget proposal that would continue expansionary fiscal policy with an expenditure increase of 27.4 percent and a projected deficit of 0.6 percent of GDP. A chorus of criticism, from economists, the central bank, and the IMF, greeted the Ministry of Finance proposal, which will replace the provisional financing utilized by the lame duck Kostunica government. Economists labeled the budget as expansive and a threat to macroeconomic stability. Central Bank Governor Jelasic pledged to maintain a tight monetary policy or even tighten further if increased demand boosts inflation. Finance Minister Cvetkovic answered critics by noting that "previously signed obligations in wage policy had to be respected." END SUMMARY.

¶2. (u) The Kostunica government on June 14 sent Parliament a full budget proposal for 2007 to replace the decree on temporary financing that had provided funding to the lame duck government. The budget, if approved by Parliament, would authorize total expenditures of SRD 595.5 (USD 9.8 billion) or 25 percent of GDP, vs revenues projected at SRD 581.8 billion (USD 9.6 billion) or 24.4 percent of GDP, for a deficit of SRD 13.7 billion (USD 220 million), or 0.6 percent of GDP. However, National Bank Governor Radovan Jelasic - who still awaits re-appointment - disputed this figure, contending that the actual deficit is SRD 50 billion, or 2 percent of GDP, based on exclusion of one-off revenue of SRD 25 billion from sale of a mobile telephony license. The basic macroeconomic assumptions for the budget include GDP of SRD 2,382 billion, real GDP growth of 5.9 percent, and end-year inflation of 6.5 percent.

¶3. (u) Total revenue is projected to rise by 16.6 percent in nominal terms, while tax revenue, which provides almost 88 percent of budget income, would rise 18.4 percent, continuing the rapid increase in collections recorded in the first half of the year. VAT revenue would provide about half of tax income; VAT, excise, and customs all are projected to increase by 20 percent over 2006, while income and profit tax are projected to rise by 10 percent. The share of income and profit tax is projected at 15 percent, and for excise taxes, 17 percent. Customs revenue should contribute 9 percent of total revenues.

¶4. (u) The 20.8 percent jump in current budget expenditures (RSD 524.8 billion, net of capital outlays) is driven by a 22.2 percent increase in salaries for public employees, to which the previous Kostunica government agreed in the run-up to January elections; payroll is 29 percent of current budget expenditure. Transfers to the pension, health and unemployment funds, which make up another 28 percent of the current expenditures, will rise by 14.6 percent. Transfers to other levels of governments, which represent 10.6 percent of expenditures, will rise 54.9 percent, while social payments, including the transition fund, allowances for children, the poor, veterans, etc., will increase 16.3 percent. Even subsidies are up 15 percent.

¶5. (u) New Finance Minister Cvetkovic fulfilled his pledge to move outlays for the National Investment Plan (NIP) on-budget; the new

spending plan increases NIP outlays by a factor of five, to SRD 44.3 billion (USD 731 million). Overall, capital expenditure would more than double, to SRD 70.6 billion, or 11.8 percent of total expenditure.

¶6. (u) The consolidated budget of the general government includes not only the central government but also the budgets of Vojvodina's provincial government, local government and the Pension, Health and Unemployment Fund. This budget is projected to reach SRD 995.7 billion (USD 16.3 billion), or 41.8 percent of GDP. Overall government revenues are projected to reach SRD 986.1 billion (USD 16.2 billion), or 41.4 percent of GDP, leaving a consolidated budget deficit of SRD 9.3 billion (USD 100 million), or 0.4 percent of GDP.

¶7. (u) Finance Minister Cvetkovic explained that the budget was imposed on the Ministry by large salary increases for the public sector agreed in late 2006 before the election campaign. Salaries of budgetary users will increase by 22 percent on average through 2007, but salary growth will slow in the second half of the year, he promised. However, Cvetkovic expects the 2007 budget deficit to be much lower in execution than projected because NIP spending requires detailed plans and time-consuming public procurement procedures. Since just SRD 9 billion was spent for NIP in the first half of 2007, it is unlikely that the projected 35 million can be spent in the second half.

¶8. (u) Serbia will continue to run a primary surplus, with interest payments budgeted at SRD 17.4 billion, and overall debt service, at SRD 58.6 billion. The finance minister contends that Serbia is not a highly indebted country since public debt in 2006 was USD 12.4 billion, or 32 percent of GDP, of which domestic debt accounted for USD 5 billion.

## Analysts: Expansionary Budget a Threat to Prices

¶9. (u) All observers agree that the budget is too expansionary, with projected outlays increasing 27 percent over 2006 in nominal terms, or 21 percent in real terms. NBS Governor Jelasic said that the budget will not support price stability and could lead to more restrictive monetary policy if inflation rises in response to increased demand. He also observed that the draft 2007 budget will not "open the IMF door for Serbia" since the Fund's April mission recommended a healthy surplus to preserve macroeconomic stability, vice the budget's 2 percent deficit.

¶10. (sbu) IMF Resident Representative Harald Hirschhofer publicly warned that the draft budget could deepen macroeconomic risks by causing even faster growth. Fiscal stimulus was limited to a degree in the first half of 2007 by the spending limits imposed by the temporary financing decree, but realization of the proposal 2007 budget would mean fiscal expansion in the second half of the year, he points out. He recalled the IMF recommendation for a fiscal surplus in 2007, increased efficiency in public spending, fast privatization of public companies and revision of NIP. Privately, Hirschhofer told a group of donor country officials that the deficit could be as high as 3 percent of GDP and would increase the trade and current account deficits even more.

¶11. (U) Independent analyst Vladimir Gligorov - who is close to the opposition Liberal Democratic Party - called the budget populist and warned that the central bank will have difficult task to keep inflation in the target range of 4-8 percent. Stojan Stamenkovic, of the Economics Institute, agreed that the budget is too high and called for a cut of SRD 25 billion to harmonize fiscal and monetary policy. If this budget is not reduced, he warned, the central bank will be forced to tighten monetary policy by raising interest rates, leading to appreciation of the dinar and an increase in imports of some EUR 1.5 billion.

## Opposition: A Status Quo Budget

¶12. (U) Opposition deputies announced they will not support the budget. Serbian Radical Party (SRS) deputies claimed that budget was drafted without clear goals and "is not based on the current Constitution." Socialist deputies will vote against it since the budget has "an especially high deficit in the field of health protection and a large number of people would remain without

appropriate treatment or certain drugs." The Liberal Democratic Party (LDP) cannot support the budget due to the way it was proposed in the Parliament as well as the character of the budget itself, said LDP leader Jovanovic, calling it a "budget that sustains status quo in Serbia".

## Tax Breaks to Fulfill Pre-election Promises

¶13. (U) On June 14, the Ministry of Finance also proposed amendment of several tax laws, amendments that would fulfill pre-election promises of the Democratic Party, which nominated Cvetkovic as minister (although he says he is not a party member). The Ministry proposed to decrease the tax rate on real estate transfers from 5 to 2.5 percent, with a full tax holiday for those purchasing their first apartment; end the VAT on purchases of new apartments by first-time buyers; decrease VAT for purchase of personal computers from 18 to 8 percent, and decrease collections from several other taxes.

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